

D. Yu. KRETOV,

Odessa National Economic University, Odessa, Ukraine

**THE CYCLICALITY OF THE CREDIT MOVEMENT IN THE
TRADITIONAL AND
ISLAMIC MODEL OF THE BANKING SYSTEM**

Abstract

Objective: to define the features of the cyclicity of the credit movement and the traditional model of the Islamic banking system, to carry out a comparative analysis of the results and to prove the necessity of developing effective methods of regulating the credit movement for banks in Ukraine.

Methods: analysis and logic synthesis, analysis, synthesis, comparison and system analysis, grouping data, methods of theoretical knowledge.

Results: Under the influence of the rapid development of financial globalization processes banks of almost all countries of the world admitted shortcomings in the organization of the credit activity: significantly reduced the requirements for determining the creditworthiness of borrowers, allowed uncontrolled credit expansion that led to the credit bubble and caused a devastating impact on the world's overall development in 2008-2009. Enhancing the amplitude of the credit cycle has resulted in corresponding fluctuations in the economic cycle. Thus, the countries with the traditional model of the banking system underwent a greater financial loss than countries with an Islamic model. The research proved that in contrast to the traditional model of banking, fluctuations of the credit and economic cycles in Islamic countries are more proportionate and balanced. The proposed development provides an effective system of countercyclical regulation of the banking sector, by means of which rational management of the credit movement and processes of credit granting loans based on achieving an appropriate balance between the development of the real and financial sector that would minimize

fluctuations in the credit cycle and contributed to the overall economic growth, would take place.

Scientific novelty: based on comparative analysis the necessity of using the experience of Islamic banks in bank credit operations in Ukraine is proved and substantiated.

Practical significance: the conducted research proves the necessity of developing and implementing new approaches of management of credit operations and credit risks in practical activities of banks in Ukraine, taking into account the cyclical economic development.

Keywords: credit, credit cycle, cyclicity, credit resources, traditional banking model, Islamic bank, credit expansion, financial globalization.

Introduction

The recent crisis phenomena and trends of the global financial and economic space allowed to obtain a conclusion concerning the absence of effective regulation of credit institutions by the state. Under the influence of globalization national banking systems become highly dependent on external factors and lose their ability to respond to changes in the global financial environment quickly and efficiently as well. However, most vulnerable link is the credit activity of banks, which significantly affects the economic development of countries. The uncontrolled credit movement under the influence of financial globalization caused a devastating impact on the world overall economic development in 2008-2009. Enhancement of the amplitude of the credit cycle led to corresponding fluctuations in the economy and ultimately to the overall financial and economic crisis. Thus, the countries with the traditional model of the banking system underwent a greater financial loss than the countries with the Islamic model. Our country, whose banking sector has not caught up with the rates of the pre-crisis growth up to the present time, is not an exception in this case.

Therefore it is necessary to define clearly the most effective instruments of controlling the credit movement on the basis of the traditional and Islamic models of functioning of banking systems. It actualizes the analysis of the main indicators of the

bank credit activity and based on this identification of the main advantages and disadvantages of these models.

Scientific works were dedicated to the research on the cyclicity of the credit movement and its management in the traditional and Islamic models of the banking system by such foreign scientists as A. Erche, G. Horton, G. Kaminski, Ch. Kindelberher, N. Kiyotaki and J. Moore, L. Laeven, T. Makkalom, D. Burakov, K. Reinhart, L. Fernandes, etc.

Among the causes of the global financial crisis, which lie within the traditional banking operations, scientists A. Erche, L. Fernandes [1] K. Reinhart [2], distinguish excessive lending for a long time. L. Laeven [3] and M. Chapra [4] define the crisis as a part of the economic cycle identifying a number of specific factors that can contribute to its deployment, namely the excessive use of speculative assets and derivatives, securitization, unsatisfactory performance of the creditor's role and supervisory functions by domestic banks and international organizations.

We agree with D. Burakov's idea that determines the cyclicity of the credit movement as a continuous process of accumulation and resolving conflicts that arise during the movement of the credit as a system of the relationship between the creditor and the borrower on the reverse movement of borrowed value. In his opinion, using the experience of the traditional and alternative Islamic model will identify areas for further improvement of the credit sector to ensure the financial stability of national economies and protect from widescale crisis shocks [5, p. 47].

Among domestic scientists, whose works are dedicated to the problems of the cyclicity of the credit movement, M. Gasanov, V. Korneyeva, A. Navanova, V. Pavlova, O. Chuhayeva, A. Cherednichenko, T. Chernychko, etc. should be noticed. V. Korneyev considers that positive aspects of the functioning of the Islamic financial model in terms of transparency of credit transactions and reliability of bank investments are worthy of distribution in the domestic banking sector [6, p. 314].

O. Chuhayev and A. Cherednychenko prove in their studies that in the short term Islamic financial institutions will reach the significant spread in the world and

Ukraine, for which the basis and relevant necessity have already existed, and the experience of Islamic banks is worthy of attention of domestic bank management.

Paying tribute to the scientific achievements of foreign and domestic scientists, it should be noted that today the number of studies of the phenomenon of the cyclicity of the credit movement increases. This definition of features and comparison of credit cycles in the traditional and Islamic models of the banking system are nearly absent. Therefore, the proposed article is dedicated to the issues of definition of the features of the credit movement in these models and the definition of its main patterns and factors influencing it.

The main aim of the study is a comparative analysis of the cyclicity of the credit movement in the traditional and Islamic models of the banking system and determination of the most effective instruments of controlling the credit movement on their basis.

Research results

The results of the global financial crisis in 2008-2009 indicate the vulnerability of national banking systems to the global crisis phenomena. Disability of the instruments of macroprudential regulation to effectively counteract the processes of financial globalization, which has led to the acceleration of the capital movement, information asymmetry, significant dominance of the financial sector over the real one as well as the emergence of many types of speculative trading, has led to major losses for the entire development period of the global financial space. However, the main driving factor of the global crisis was unsecured and inefficient use of bank credit resources that affected the fluctuating amplitude of the credit cycle. This led in its turn to an increase in cyclical economic environment and intensified the crisis even more.

The conducted comparative analysis of the traditional and Islamic model of functioning of banking systems based on performance of banks in the European Union, the United States and the Arab world shows that banking systems that operated on the traditional model underwent more loss, than those that operate on the Islamic one.

In the traditional model the market mechanism should ensure regulation on the credit market through incentives and restraining factors that create the conditions for making profit or loss. The main source of income in the traditional model for banks is the interest they receive through the mechanism of lending. Also losses occur when a borrower is unable to repay the loan and interest. Thus, to avoid unprofitable lending banks have to analyze the creditworthiness and solvency of borrowers. However, this protective mechanism that prevents excessive credit growth can be created only provided fair profit and loss spread (PLS), which in the traditional model of banking systems does not exist.

Instead of forcing banks and investors to share the risks of business, the traditional banking model almost exempts them from the latter. Thus, the market becomes unable to control its members, leading to an uncontrolled increase in bank loans, excessive leverage and providing loans to insolvent borrowers [7, p. 286]. Due to these processes, the strengthening of cyclical fluctuations of the credit movement and its acceleration take place.

During the period of the economic growth the absence of equitable sharing risks and profits worsens the state of the credit market and creates problems in the financial system. This trend allows market participants to borrow exorbitant sums, and move the capital quickly at the slightest change in the economic environment. That is why interest rates and asset prices are very volatile, that creates uncertainty on the investment market and prevents the formation of capital and rational use of credit resources. Thus, the short-term lending market becomes more attractive to creditors and borrowers than the long-term lending market [8, p. 288]. The result is a sharp increase in short-term borrowings for the investment purpose that contributes to strengthening economic and financial instability.

So, as a result of the analysis, it was found that the characteristic of the traditional model of banking is the close direct link between the economic growth rate on the step-up phases of the cycle and the growth of prices on the markets of goods, services and assets. The presence of such interrelation is the evidence of a dependence of the economic growth on price rising on different markets. At that the

economic growth of developed and developing countries is largely characterized by the formation of bubbles on different markets, which not only enhance the economic growth in the short term, but also reinforce the price pressure on several markets. In 2008 the indicator of the credit depth of the European Union was up to 1.17 pp. indicating the excess of amounts of the financial sector over the real one by 17 %. As for the United States, the figure was 1.98 pp., which is twice as much as the GDP, and shows unsecured functioning of the economy [9]. The same thing occurs to the relationship between the credit expansion and price levels. Active expansion of bank credit operations led to a significant rise in prices of estate, cost of services, consumer boom, and as a consequence - higher prices. As a result, it can be concluded that prices largely depend on the credit expansion of current banks simultaneously supporting the economic growth rate.

The rapid growth rate of economic globalization of the countries with the traditional model of the banking system in the pre-crisis period can also be considered as one of its main features. Indeed, globalization is first seen solely as a positive phenomenon, which led to the liberalization of national protective barriers and growth of economy dependence on external financing.

Another important feature is a direct link between the economic growth and the credit market both at the recovery phases and at the phases of recession. So the growth rate of economics and lending the countries of the European Union in 2008-2009 amounted to a negative value of 10.66 pp. and 4.4 pp. respectively [9]. The same trend is taking place in the USA. This, in turn, shows the relationship between economic and credit processes. At that the relationship can be traced between the amplitude of the economic downturn and the credit market and the increase of the proportion of the past-due debt. So a significant slowdown of increase in lending and economics is accompanied by a significant growth of bad loans.

The Islamic model of operation is more resistant to the crisis, because the regime agreement is used in it. Wherein money is not a commodity and has no internal value, even if it is spent. The only advantage of money is to convert its monetary function into the economic function either by trade or by investment. Thus,

the Islamic bank, as a follower of the Sharia principle can not invest in any product that it needs.

The Islamic bank doesn't sell the debt and it does not invest in distressed assets and mortgage-backed securities. As a result of comparative studies, it was found that during the crisis of 2007 and 2008 the profitability of both Islamic and conventional banks decreased. However, the profitability of Islamic banks decreased by less than 10% and the profitability of traditional banks underwent a decrease of more than 30% [9].

Smaller investment portfolios, lower measure of leverage and commitment to the principles of Sharia, which did not allow Islamic banks to engage in financing or investing in the kinds of instruments that adversely affected their traditional competitors - everything contributed to the achievement of better results compared to traditional banks. In most banks internationally a sharp reduction in credit followed by rapid growth in lending as soon as the crisis began, in contrast to Islamic banks, which lending retained positive dynamics. Thus, lending in Arab countries has increased by 17.4 % since 2008-2009 [9]. Also assets of Islamic banks have grown up fast. It was found that on average, this growth was twice as fast as the growth of traditional bank assets in 2007-2009.

Also, unlike traditional models, fluctuations in the credit and economic cycles in Islamic countries are more proportionate and balanced. In the traditional model, we can see a relatively low rate of the economic growth with a deep fall in the GDP growth during the crisis, indicating the presence of imbalance between the economic and financial spheres. The interrelation between economic expansion and inflation is positive. Unlike the traditional model, the Islamic financial model does not make a significant impact on the formation of bubbles on markets of goods, services and assets, because there is no speculation.

The indicator of economic globalization in its turn slows down a bit, but continues its growth during 2007-2009 that indicates effective policy of macroprudential regulation of the banking sector regarding outside influence.

There is a proper balance between the economic growth and the growth in lending as well as the balance between the growth of lending on the phases of recovery and the growth rate on the phases of recession, indicating a lower amplitude of credit and economic cycles. As a result of the analysis an inverse relationship between the economic growth and credit sectors during the recession and the growth of the past-due debt was found. This indicates the existence of proportionality between the amplitude of recession and credit sector, and an increase in the past-due debt, indicating the weighted ratio of creditors to the risk.

Conclusion

The traditional practice of banking mediation provides extensive use of credit and transfer of risks, while Islamic banks offer financial services that are based on joint investment activity and risk sharing, which in turn prevents a significant increase in the cyclical nature of the credit movement. Respecting religious principles of Sharia Islamic banks made it impossible to invest financial resources in speculative instruments, which were the main factors of increase of the amplitude of the credit cycle of current global economic crisis in banking systems with the traditional model. Thus, in the period of 2005-2007 the average profitability of Islamic banks was lower than traditional banks, that is explained by a much lower level of risk of Islamic banking operations that are based on respecting religious Sharia norms.

However, during the crisis period in 2007-2009 the rate of loan growth and the increase in assets of Islamic banks were on average 70-80% higher than traditional banks. Modern paces of lending of Islamic banks have significantly exceeded their pre-crisis level, while most of the banks of the European Union and the United States have not reached the pre-crisis indicators.

The same happens to Ukrainian banks. The effects of the global economic crisis in 2008-2009 and the political crisis in 2014 affected the development of the national banking sector negatively. Taking into account the faults in macroprudential regulation of previous years and basing on the main benefits of the Islamic and traditional banking models, Ukraine needs to develop an effective system of countercyclical regulation of the banking sector, by means of which rational

management of the credit movement and processes of granting loans would occur. With this system an appropriate balance between the development of the real and financial sector credit has to be achieved, credit cycle fluctuations have to be minimized and the overall economic growth of the country has to occur.

References

1. Balteanu, I. *Bank Crises and Sovereign Defaults: Exploring the Links*, Mode of access: <http://www.econ.unavarra.es/seminarios//120119%20Erce.pdf>.
2. Reinhart, C. *The Twin Crises: The Causes of Banking and Balance-of-Payments Problems*, 2009, Mode of access: http://www.economics.harvard.edu/faculty/rogooff/files/Is_US_Different_RR_3.pdf.
3. Laeven, L. *What Drives Bank Competition? Some International Evidence*, *Journal of Money, Credit and Banking*, 2012, 36(3), Mode of access: <http://ideas.repec.org/p/wbk/wbrwps/3113.html>.
4. Chapra, M. *The Global Financial Crisis: Can Islamic Finance help?*, Mode of access: http://www.isdbforum.org/presentationPapers/5-M_Umer_Chapra.pdf.
5. Burakov, D.V. *Upravleniye tsiklichnost'yu dvizheniya kredita (The management of the cyclical nature of the credit movement)* / Moscow: Rusayns, 2015, 288 p.
6. Korniyev, V.V. *Islams'ka finansova model': osoblyvosti rozvytku / Visnyk sotsial'no-ekonomichnykh doslidzhen' (The Islamic financial model, features of development)*, *Socio-Economic Research Bulletin*, 2012, № 1(44).
7. Kuznyetsova, L.V. Andreyeva, YA.S. Zherdets'ka, L.V. *Diyal'nist' bankiv na kredytnomu rynku v umovakh asyemetriyi informatsiyi (The activities of banks on the credit market in terms of asymmetric information)*, Odessa: ONEU, 2015, 289 p.
8. Kuznyetsova, L.V. *Kredytnyy menedzhment (Credit Management)*, Odessa: ORIPA NAPA, 2007, 332 p.
9. International Bank for Reconstruction and Development, Mode of access: <http://www.worldbank.org/>

Dmitriy Y.

Kretov, graduate student, teacher of the Department of Banking, Odessa National Economic University

Address: 2\2 Dmitriy Donskoy Str., 65016, Odessa, Ukraine, tel.: +380630737957

E-mail: dmitriy.kretov@gmail.com

ORCID: orcid.org/0000-0001-7129-4040